DOW THEORY LETTERS INC.

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Thought for the week: In the past six months this primary bear market has wiped out better than 25% of the Industrial (Average) gains of the past seventeen years (since 1949).

THE MARKET: The third (downward) primary leg of this bear market started in June at 903.22 on the Dow. Despite minor rallies in June, July and August, the third primary leg continues. As this is written all the Averages were probing new low territory for the move. In the last Letter I concluded by saying, "I cannot be sure, but I sense that this market is just on the edge, the very edge of panic." Nothing has occurred since then to change my mind.

The first (psychological) phase of the bear market is over. A good deal of the "froth" of the preceding bull market's last phase has been brutally lopped away. We are now in the second phase of the bear market, and this is the phase where the business news and the stock market go down together. Broad panics usually mark the progress of the second phase. There is no doubt about it, the bear is holding Wall Street tighter and tighter in its powerful grip. The last vestiges of bull strength are ebbing, and the bear senses the kill. Consider this--in 1962 we witnessed a 120 point crash, and that occurred within the context of a continuing bull market. Can we expect to escape a crash (and a worse one) now that a primary bear market has taken over? I do not think so. Already some individual stocks are beginning to crash. Many airlines are down 1/3 or more in value over the past week. The whole downward movement is gathering momentum and the damage is awe-inspiring. The nation is about to receive a lesson in mass psychology within a primary bear market. Those of us who escape unscathed will be in the tiny minority. Fear is man's strongest and most contagious emotion and it is about to run rampant.

Right now I am not encouraged by the steady buying on the part of the odd-lotters. The odd-lot public has, so far, shown little if any disposition to reduce buying as the market declined. As a general rule, odd-lotters will sharply reduce their buying (or step up their selling) prior to a bottom. As far as odd-lot shorts are concerned, they normally increase their activity during any decline (they are always encouraged by lower prices). The greatest credence should be accorded the odd-lot ratios, and the odd-lot short figures should only be used as a confirmation. So far, the ratios are not encouraging for a turn at this time.

Nevertheless, from every quarter comes the question, "Has the decline bottomed out?"

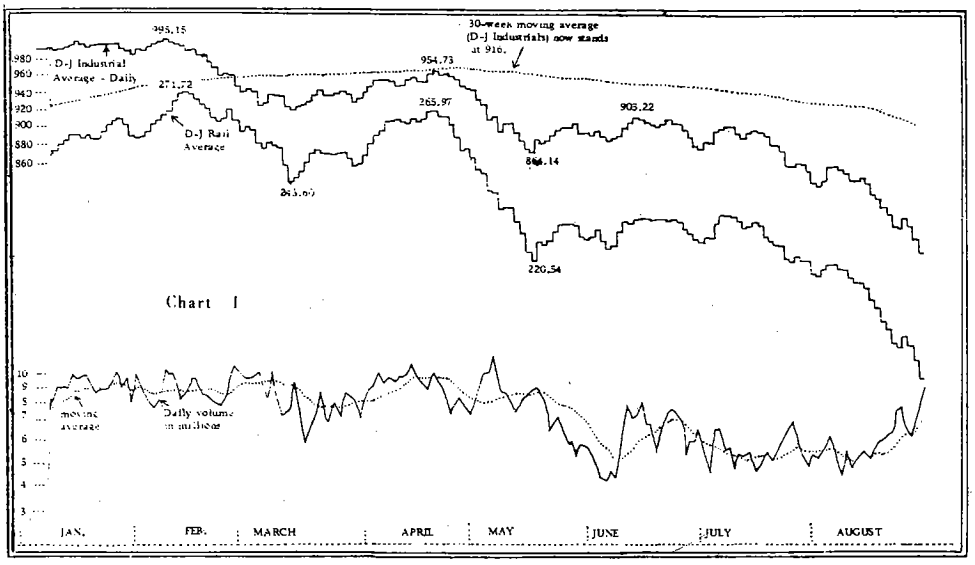
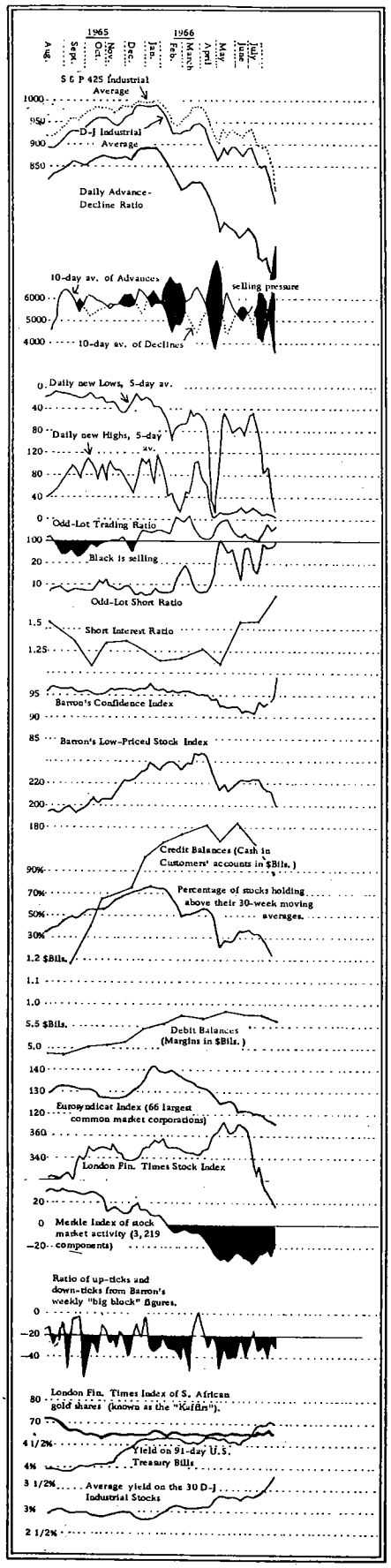


Chart I


1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index (66 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

Guessing at temporary bottoms is always hazardous in bear markets; it's as difficult as putting out shorts at bull market rally-tops, just prior to secondary corrections. That is the reason why I have urged all my subscribers to concentrate on the big picture. In general, rallies in bear markets afford opportunities for sales, and new subscribers who have not yet "cleaned house" should heed this advice. In the case of older readers, I trust that they have already placed themselves in a highly liquid, defensive position.

It may interest subscribers to know that there is a time in which it is profitable to buy during a bear market. That time is following a true high-volume crash. After a crash the averages usually stage a mild recovery, then sink to new lows for the move. But the new lows are recorded on lower volume. Then (almost without exception) there is an automatic recovery which serves to retrace approximately half of the ground lost during the panic and crash. Therefore, if we do experience a true crash in the period ahead I will almost surely recommend trading commitments following the collapse. But barring a crash, I continue to insist that my subscribers adhere to the policy which has proven wisest in every bear market. That policy is simple: "Get out, and stay out!"

There has been more downside compression in this bear market so far than at any time since 1937. Analysts have been shouting "oversold" for weeks, but an oversold condition in a primary bear market is a different animal than an oversold in a bull market (as I have so often warned). On August 24 the advance-decline ratio broke below its 1962 low, a shocking performance! If this had occurred within the framework of a primary bull market I would say that it could have bullish implications since the Industrial Average has not confirmed. But coming, as it has, within the framework of a bear market I would say that it is very bearish. It suggests to me that before this bear market is over, the Industrial Average could easily confirm the A-D ratio by penetrating its own 1962 (Industrial) low of 535.76.

NOTES AND QUOTES: Stock market analysis can never and will never be reduced to a mechanical basis. Many analysts and services who prided themselves on their "systems" over the past few years have discovered this truth recently--to their sorrow. What everybody watches ceases to be a strong factor on Wall Street. Thus, it was said that this couldn't be a bear market since no bull market has ever recorded its high in February. It was said that debits (margin loans) have to be in a strong downtrend before a bull market tops out. It was said that credit balances had to be declining before a bull peak. It was widely held that no bull market could top out with a huge short interest. It was felt that the low-priced stock indexes always turned down before the D-J Industrials stocks. It was said that the peak volume of April and May, coming after the lower volume of January and February, implied new highs for the Averages ("volume always tops out before prices"). It may never happen again in the same way, but the 1966 bull market top made hash of all the old gauges and indicators. Market forecasting is still more art than science.

* * * *

From the latest (August 15) issue of the BANK LETTER, First National Bank in Dallas: "There is some hope that we have seen the top in interest rates and that further restrictions will not be forthcoming, but the hope is meager. Too many uncertainties still muddy the economic waters. For some reason not clear, we seem to insist on pushing down on the accelerator and on the brakes at the same time. Letting up on the accelerator appears to be long overdue."

* * * *

From the latest issue of the London ECONOMIST: "Plain speaking has been in unusually short supply among American official statements about the Vietnamese war lately. General Greene, the Commandant of the Marine Corps, was reported to have confided to the press in Saigon that, according to government studies, the war would last 8 years unless the Americans brought in 750,000 troops, in which case the war might be over in 5 years. But a few days later, back in Washington, he contradicted the report, as the Dept. of Defense had already done not very convincingly."

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An interesting excerpt from a subscriber in Santa Barbara: "Before closing this I would like to talk about honesty or the lack of it in our news releases. We recently had a situation here in Santa Barbara where the most costly housing development (in the extremely high priced bracket) went under. The big news release went thusly; "Bonneymede Under New Management". The article went on to tell of the big things ahead under the NEW management. Near the end it stated, "the new managers are the PASADENA BUILDING & LOAN." No mention was made of foreclosure.

"This disturbed me so much I went out and talked to a banker to make sure I was right.

"Then another headline in the L.A. TIMES: "Brokers State Second Mortgage Money Market Active". This sounded good but when you got into the article you found that 10% second mortgages were often selling at 70% discounts. Or... to put it another way....if you needed $3,000 you might have to sign a second for $10,000.

"The above are only two reasons of WHY the public does not really know what is going on." (W.F.M.)

* * * *

Last week Federal Reserve Board member J. Dewey Daane complained that interest rates were too high, but he said this was "inevitable" because of present inflationary pressures. Last week Under Secretary of the Treasury Deming cheerfully reported "quite substantial progress" in the field of international monetary reform. Last week the French Government in a report warned against premature monetary "mechanisms" which would endanger world finance. Last week Chairman Patman of the House Banking committee chided President Johnson for lack of interest in lowering interest rates. Last week Senator Douglas warned against boosting interest rates further in order "to keep European hot money in the U.S." Last week, in U.S. News and World Report, the following interesting item appeared: "Henry Fowler, Secretary of the Treasury, is said to be giving thought to a return to private life in the not distant future..."

* * * *

Barron's Confidence Index has taken a big upward jump--but in a very strange way. The Index (which is a ratio of the yield on the Highest Grade Bonds and the yield on the broad 40 Bond Index) rose because High Grade bond yields rose faster over the past few weeks than the 40 Bond yields. It was simply a question of all bonds collapsing, with the High Grades making up for lost time. It strikes this writer that this is hardly a bullish way for the C.I. to rise.

The next critical point to watch on the downside (see Letter 330, page 4) is 765.46. This is the halfway level of the entire 1962 to 1966 rise. If the Industrials close decisively below 765.46, the 50% Principle will be saying that in time the Industrial Average will approach or break below the 1962 low.

It's a strange phenomenon, but when the market is dropping people seem to feel better if they can "understand" the reason for the decline. In an attempt to satisfy this need on the part of the public, newspapers and financial sources have been offering their "guesses" and opinions as to the reasons for the decline. Personally, I always find such explanations rather pathetic. Tight money is now a fact of life, everybody knows about it, and everybody knows that money can get tighter. For this reason, I feel that the market has discounted the money situation to a large degree. Yet each day of decline is blamed on tight money. "The reason for the market's movements," wrote William P. Hamilton, the great Dow Theorist, "are often known in retrospect but seldom at the time."

My own thoughts are that the market has been declining because it has been discounting a rash of bearish news, news which will be out for publication a few months to a year from now. And the biggest single piece of news is apt to be the simplest and most frightening of all. That news could be that we are on the edge of a sharp downturn in business. "Tight money in the face of a boom," we are told. "Plenty of troubles, but still inflation and torrid business activity." But I am sceptical. I think we are more liable to see a severe business contraction, and with it a whole raft of business troubles brought on by "unexpected" developments. After all, why couldn't business turn down? Why couldn't the price of commodities, real estate, merchandise and everything else head down much as the stock market has done? Remember, we have all been brainwashed by 16 years of almost steady economic expansion and "New Economics" propaganda. But the primary trend has turned bearish. Only 7 months ago, it was considered "only a matter of time before the Dow betters 1000." Now that possibility is largely written off. Nevertheless, most people are still thinking in terms of steady (but perhaps more restrained) economic expansion. I feel that in another 6 months or so, this thesis too will be forgotten as the forces of contraction and deflation sweep over the land.

Along these lines it is also interesting to note the character of the activity whenever strength comes into this market. Interest immediately centers on the glamour stocks and the former high flyers, and this suggests to me that we are still in the early stages of this bear market. For the phenomenon of money rushing back into the high flyers is a conditioned reflex, a vestige of the previous bull market psychology. During a bear market this type of psychology is subject to gradual change, and this is how it happens. As a bear market progresses, less and less interest is shown in the growth stock concept, and more and more interest is accorded the concept of value. Finally, during a real economic collapse almost all the former growth and glamour stocks will be affected by the adverse economic forces, and these stocks will then become "contraction stocks" like everythink else on the Board.

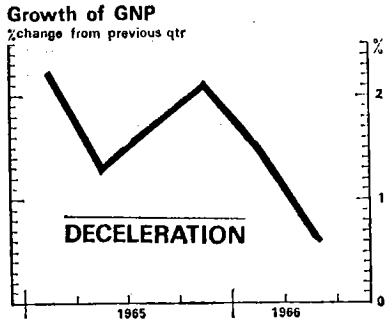
What happens then? Simply this, investors will turn back to yield or to return on their money. "If I'm going to put my hard-earned cash into this market," proclaims the seasoned investor, "then I darn well want a good and safe return while I wait." So the investor turns to dividends and dividend coverage. It is as simple as this, at a certain price General Motors is an obvious value, based on a long history of earning power, stability, dividend payout, etc. For instance, at 5 or 6 times earnings with a dividend yield of 8% or 9%, GM has always been a good long-term holding (i.e. a value). But Xerox, down from 267 to below 200, with 1965 earnings of $2.78 and a $1 dividend, what is it worth in a primary bear market? What is Xerox worth if its business and earnings start contracting. Is it worth 100, 90, 70, or 50? I simply have no idea.

The point is this. Before this bear market is over, it is probable that we will again see the rallies lead by the old-fashioned values. It is probable that we will again see the blue-chips leading the market as investors turn back to the concept of safety, yield, dividend-coverage and value. Value is the word to remember. For the nearer we get to the bottom of this bear market, and the nearer we get to the birth of the next new bull market, the more stress we can expect to be placed on value. I don't have any idea where Xerox or Admiral or White Consolidated will be or what they will be worth when this bear market hits bottom. But I do know that there is an historical basis for building a fortune when one buys Anaconda, Bethlehem Steel, General Motors and Sears at bargain-basement prices at the bottom of a bear market.

EXPECT THE "UNEXPECTED": Back in 1949 when the great bull market of 1949-66 began, few expected the long series of bullish events, events which were to be reflected by the stock market's amazing climb (Industrial Average) from 161.60 (1949) to 995.15 (1966). Few expected the great Government-sponsored inflation of the 1950's and '60's, and few expected public acceptance of the Welfare State and the New Economics. How many foresaw the giant boom in consumer credit and the fabulous speculation in land, precious stones, stocks, objects of art and coins, etc. Yet all of this occurred, each reacting on the other and each feeding and fanning the flames of inflation.

A primary bear market is currently upon us. One wonders what "unexpected" events will arise during the bear market, events which are not dreamed of or even hinted at today. I often ponder about certain situations which I feel would shake the complacency of today's investors. These are events which could serve to justify substantially or unexpectedly lower levels for the market. A few of these "brainstorms" are listed below.

(1) A drop in Government receipts in the face of mounting expenses could occur. We know that in 1929-32 the national income dropped about 50%. Consequently, money collected by the Government in the form of individual and corporate tax receipts also diminished substantially. But in 1929 the national dept was only $16 billion vs. $330 billion today, and during the 1930's the nation's entire outstanding debt was diminutive compared to the debt today. Therefore, I wonder what would happen if Government receipts dropped even 15% over the next year or so. Would a frantic Treasury have to fill the void with giant new bond issues, and would taxes have to be raised? Would the Government have to embark on a massive anti-spending program? Along this line of thinking, few people now realize that the growth in the U.S. Gross National Product is now decelerating rapidly, and this could be an ominous sign. The accompanying chart shows the quarter to quarter comparisons (in percentages) since early 1965. It certainly suggests the possibility of a contraction in the GNP shortly. Wouldn't that be a shocker!



(2) Could President Johnson literaly "call off" the war in Viet Nam, with the excuse that this nation simply cannot afford it? If the stock market collapses, if a recession arrives, if the Government decides that it wants to divert Viet Nam spending to the domestic front, then couldn't Johnson terminate the war in Viet Nam? If the situation in this country becomes grim enough, I could conceive of the war being called off.

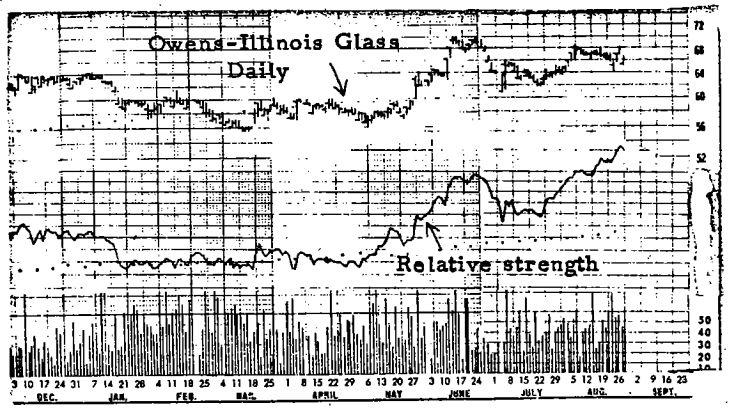
(3) A rash of bankruptcies, setting off fear and mistrust, and a general movement back to cash; I wonder if this is not a distinct possibility. Certainly in the construction and finance area such as the savings & loan associations we have heard of a few sundry insolvencies. If this type of distress were to widen and spread into other industries, the public might begin a general exodus out of "things" and into cash again. Such action would hit retail sales hard, and again a whole series of bearish possibilities arise.

(4) I have discussed before the possibility that deflation, rather than inflation, could be the problem of the next few years. A real estate firm next door to my office has posted this sign: "Waiting for housing prices to come down? Prices could be 20% higher by 1970." This arrogant approach to selling (based on what has been) could prove to be as wrong as it is distasteful. During primary bear markets deflation is the usual course of events, and I would say that we might well expect a decline in the price of almost everything over the period ahead (yes, including wages). Already we are seeing a decline in the price of copper and a few other assorted metals. If deflation did occur, then businessmen would not want to hold inventories. They would want to conduct their businesses on a hand-to-mouth basis, since prices they pay for goods would be heading down. The currently "fat-cat" consumer would feel little if any compunction to buy, since "things are probably going to be cheaper next year anyway." Such a situation would certainly have far-reaching implications.

(5) A collapse in the stock market could produce widespread resentment, bitterness and reappraisal on the part of the American people. If the promises of the Great Society backfire, then political and social moods could change drastically. In fact, there could be a turn towards conservatism in this country, and this is not as impossible as it sounds, since there is an underlying Puritan ethic which runs through the fiber of a large part of our population (it is particularly noticable in the mid-West and far-West). A major bear market could stir great resentment on the part of the public towards the New Economics and the Great Society. If the public decides that it has been "had," then their frustration could be vented on the politicians. In that case, change would be the order of the day.

I list the five thoughts above simply as examples of what could occur in the period ahead. I have done this because it is another way of saying to my subscribers: "Don't be complacent during a bear market." You probably have considered certain bearish contingencies which might arise in your own business, events which few outside your own business could possibly envision. Multiply these possibilities a thousand times in a thousand industries and you have the seeds of a potentially drastic bear market.

STOCKS: Although market weakness persists, I have been studying the daily charts with increasing interest for signs of rising relative strength (RS) in individual issues. Stocks with rising RS lines are those most likely to lead the next major rise. So far, the Glass, Tobacco and Domestic Oil groups are outstanding. Some of the individual stocks which I would be tempted to trade into following a crash and recovery are Liggett & Meyers Tobacco, U.S. Tobacco, Owens Corning, Owens-Illinois, Standard Oil of Ohio, Standard of Indiana, Marathon Oil, Ashland Oil. MGM and Columbia Pictures act well. The two best looking Dow stocks are Proctor and Gamble and Owens-Illinois, and I would want these two high grade issues. I include a chart of Owens-Illinois to illustrate what a stock with rising RS looks like during a general market collapse. Note the stock moving sideways (sensational action during a market cave-in) while the RS line rises to new highs. (Chart of OI courtesy of Traders Research, Inc., 1431 Pearl St., Alton, Ill. 62003.)



LATE NOTES: This generation has never seen the stock market and the bond market fall apart together. But that is exactly what has been happening. Note on the accompanying quote-box that selected U.S. Treasury bonds are now pushing into the 6% yield zone, thereby offering the juiciest yields seen in 40 years! Barron's Treasury Bond Index (see Letter 329) last week smashed through its 1960 low, and it appears to me that the panic in the bond market is underway. Those who have fled from the stock market to the bond market have jumped from the frying pan into the fire. But watch the bond market. Any important turnaround should start in the bond market, and the stock market will surely follow. (As a point of interest, the breadth crashes of August 26 and August 29 were each more severe than the worst day seen in 1962. Despite volume, these were real panics in breadth with 1186 and 1240 declines seen on the two respective days).

Subscribers might be interested in an article by the writer which is tentatively scheduled for Barron's this Monday, September 5. The article deals with bear market rallies, a rather important subject these days.

Treasury Bonds

NEW YORK (AP)—Closing over the counter U.S. Government Treasury bonds, bid, asked, net change and yield for Monday.

2½s 66	99.15	99.17	...	5.62
2½s 67-62	97.24	97.28	—2	5.28
3½s 67	97.16	97.20	—4	5.29
2½s 68	96.8	96.12	...	6.13
3¼s 68	95.18	95.22	...	6.12
2½s 68 Nov	95.8	95.12	—4	6.14
2½s 68-63	92.28	93	—4	5.81
4s 69 Feb	94.30	95.2	—2	6.19
2½s 69-64 Jun	91.10	91.14	—4	5.88
4s 69 Oct	93.28	94	—4	6.16
2½s 69-64 Dec	90.4	90.8	—4	5.80
4s 70 Feb	93.8	93.12	—12	6.14
2½s 70-65	89.14	89.18	—8	5.81
4s 70 Aug	92.18	92.22	—12	6.11
2½s 71-66	88.2	88.6	—2	5.48
4s 71	91.30	92.2	—10	5.86
3½s 71	90.26	90.30	—4	5.91
4s 72 Feb	91.8	91.12	—6	5.90
2½s 72-67 Jun	85.16	85.20	—4	5.42
4s 72 Aug	90.26	90.30	—6	5.82
2½s 72-67 Sep	85	85.4	—2	5.42
2½s 72-67 Dec	84.18	84.22	—2	5.40
4s 73	89.24	89.28	—4	5.79
4½s 73	90.10	90.14	—6	5.76
4½s 74	90.8	90.12	—6	5.72
4½s 74	91.6	91.10	—6	5.66
3½s 74	88.4	88.12	—8	5.62
4s 80	88.4	88.12	—20	5.23
3½s 90	84.8	84.16	—4	5.05
3½s 83-78	80.8	80.16	—4	4.99
3½s 85	79.20	79.28	—4	4.92
4½s 85-75	89	89.8	—4	5.15
3½s 90	79.24	80	—4	4.94
4½s 92-87	88.4	88.12	—4	5.08
4s 93-88	87.12	87.20	—4	4.93
4½s 94-89	87.4	87.12	—16	4.97
2s 95	78.20	78.28	...	4.20
3½s 98	78.28	79.4	...	4.78

Prices quoted in dollars and thirty seconds.